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Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819

CANADIAN RIVER GAS COMPANY,
Petitioner,

against

JOSEPH T. HIGGINS, FORMERLY UNITED STATES
COLLECTOR OF INTERNAL REVENUE FOR THE
THIRD DISTRICT OF NEW YORK,
Respondent.

**PETITION FOR WRIT OF CERTIORARI AND
BRIEF IN SUPPORT OF PETITION.**

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CANADIAN RIVER GAS COMPANY,
Petitioner,
against

JOSEPH T. HIGGINS, FORMERLY UNITED STATES COLLECTOR OF
INTERNAL REVENUE FOR THE THIRD DISTRICT OF NEW YORK.
Respondent.

PETITION FOR WRIT OF CERTIORARI.

TO THE HONORABLE THE CHIEF JUSTICE OF THE UNITED STATES
AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT
OF THE UNITED STATES:

The above named petitioner prays that a Writ of Certiorari be issued to the United States Circuit Court of Appeals for the Second Circuit to review a judgment of that Court rendered in the above case on November 9, 1945 (R. 102) affirming a decision of the United States District Court for the Southern District of New York which had held that the petitioner was not entitled to refunds of Federal Income and Excess Profits Tax for the calendar years 1934, 1935 and 1936.

Jurisdiction.

The jurisdiction of this Court is invoked under Sec. 240(a) of the Judicial Code as amended (28 U.S.C.A. §347(a)).

The Opinions of the Courts Below.

The opinion of the District Court (R. 85-86) is not officially reported. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 95-101) is reported in 151 F. (2d) 954 (1945).

Statutes and Regulations Involved.

The relevant portions of the Revenue Acts of 1934 and 1936 are Sec. 22 (a) defining "gross income", Sec. 23 (m) providing for the deduction for depletion, and Sec. 114(b)(1) and (3) providing for percentage depletion for oil and gas wells. These sections are identical in the two acts. The relevant portions thereof are set forth in the Appendix at page 24.

The Regulations are Articles 22(a)-5, 23(m)-1(g) and 23(m)-10(a) and (d) of Regulations 86 and 94. These articles are identical in the two Regulations. The relevant portions thereof are set forth in the Appendix at page 26.

Summary Statement of Matter Involved.

Petitioner is engaged in the production and sale of natural gas. The question relates to the treatment for income tax purposes of "lease bonuses" or "advance royalties" paid in connection with the acquisition of gas leases, to lessors who retained a percentage interest in the current production from the properties.

The questions are (1) whether petitioner-lessee was entitled to treat as part of the cost to it of the gas currently produced the portion of the advance royalties allocable to current production or (2), in the alternative, whether the petitioner was entitled to base its percentage depletion deduction measured by gross income from the property on its

entire share of such gross income without deducting the applicable amounts of advance royalties.

Petitioner contends that the "advance royalties" or "lease bonuses" paid by it to lessors were amounts paid in advance for gas to be produced from a depletable interest in the gas in place reserved by the lessors. As such they would constitute cost of gas purchased by the petitioner-lessee, deductible from gross sales in computing gross income under Article 22(a)-5 of the Regulations (Appendix, p. 26). The Court below denied this claim and held that the advance royalties paid by the lessee were capital expenditures. Such expenditures were considered by the Court to be the purchase price of an immediate depletable interest in the gas in place. The Court held that the current production from this interest was part of the *lessee's* gross income.

In the alternative, petitioner contends that in determining its "gross income from the property" for the computation of percentage depletion under Section 114(b)(3) (Appendix, p. 25), it is not required to exclude the portion of the gross income from current production allocable to the advance royalties if this is held to be its gross income. The Court below also denied this claim, holding that a valid Treasury regulation required the lessee to exclude this portion of its gross income from the property in computing its percentage depletion deduction.

Questions Presented.

1. Did the Circuit Court of Appeals err in holding that advance royalties paid by a lessee constitute a capital investment by the lessee in a depletable wasting asset and do not constitute the purchase price paid in advance for gas to be produced from the lessor's reserved interest?

2. In the alternative, did the Circuit Court of Appeals err in denying petitioner the percentage depletion deduction on that portion of its gross income from the property allocable to such advance royalties?

Facts.

All the facts were stipulated in the District Court (R. 25 to 84).

The petitioner during the taxable years was a corporation organized under the laws of Delaware (R. 26).

As lessee of the gas rights under certain oil and gas leases, petitioner during the taxable years 1934, 1935 and 1936, produced and sold natural gas (R. 32-33). All gas produced was immediately sold (R. 35).

Prior to the taxable years on acquisition of the oil and gas leases the petitioner or its predecessor in interest paid to the lessors of such leases, so-called bonuses or advance royalties (R. 29-30). In addition to such advance royalties, the leases provided for the retention by the lessors of a specified percentage, usually $\frac{1}{8}$ th, of the gas produced from the property and for the payment to the lessors of the proceeds of the sale of this percentage of gas as produced and sold (R. 33).

The petitioner duly filed its corporation income and excess profits tax returns for each of the taxable years with the respondent and duly paid to him the taxes shown to be due thereon (R. 26-27, 31). In its income tax returns for each of the taxable years, the petitioner deducted percentage depletion computed on the basis of the value at the mouth of the well of the gas produced by it less royalties and rentals actually paid out during the taxable years (R. 28).

The Commissioner of Internal Revenue determined that of the total of the advance royalties paid by the petitioner or its predecessor in interest prior to the beginning of the respective taxable years, \$20,511 for 1934, \$20,309.63 for 1935 and \$15,122.80 for 1936 should be considered as allocable to gas actually produced during the taxable years (R. 30).

The Commissioner further determined that for the purposes of the percentage depletion computation, the amounts so determined for each year must be deducted from the amount of proceeds actually received during the taxable years from the sale of gas produced from the leased properties (R. 30). On this basis deficiencies in income and excess profits taxes for each of the taxable years were assessed by the Commissioner. After written protests to the Commissioner were rejected, the petitioner paid the deficiencies determined to be due and duly filed with the Collector claims for refund of such taxes, which were disallowed by the Commissioner (R. 31, 32).

In its complaint in the District Court the petitioner stated four causes of action, the first two containing alternative claims for refund of taxes for the years 1934 and 1935 under the Revenue Act of 1934, while the latter two contained similar alternative claims for refund for the year 1936 under the Revenue Act of 1936 (R. 25). As to each year the petitioner claimed the right to treat properly allocated portions of the advance royalties as *cost of gas* produced from the lessors' reserved interest and purchased by the lessee, or, in the alternative, the right to compute percentage depletion, as it had done in its tax returns, on its full share of the gross income from the property without excluding any amounts representing advance royalties (R. 1-19).

The amounts of refund of taxes to which the petitioner is entitled, in the event either of its alternative contentions

is sustained, have been stipulated by the parties, as follows (R. 36, 37):

TAX REFUNDS CLAIMED BY PETITIONER.

<u>Calendar Year</u>	<u>If Petitioner is sustained on First Point</u>	<u>If Petitioner is sustained on Alternative Point</u>
1934.....	\$3,845.76	\$1,057.60
1935.....	2,792.57	767.96
1936.....	2,268.42	623.82
Total.....	\$8,906.75	\$2,449.38

The Decisions Below.

The District Court considered that the "applicable authorities" precluded the petitioner's right to recover any of the claimed refunds and therefore dismissed the complaint. The principal authorities relied on were *Quintana Petroleum Co. v. Commissioner*, 143 F. (2d) 588 (C. C. A. 5th, 1944) and *Sunray Oil Co. v. Commissioner*, 3 T. C. 251, since affirmed 147 F. (2d) 962 (C. C. A. 10th, 1945), cert. den. 65 S. Ct. 1201 (R. 85-86).

The Circuit Court of Appeals held that the portion of the current gross income from the property allocable to advance royalties was gross income of the petitioner-lessee because it was production from a depletable interest in the gas in place which the lessee acquired by payment of the advance royalties. The Court treated the advance royalties as a capital investment by the *lessee* in a depletable economic interest in the gas in place and hence not part of the purchase price of gas bought for resale. This treatment of advance royalties is in direct conflict with decisions of this Court as to the tax effect of the receipt of advance royalties by *lessors*. In *Burnet v. Harmel*, 287 U. S. 103 (1932), this Court held that advance royalties were taxable to the *lessor*

as ordinary income and that the *lessor* receiving such payments had made no sale or exchange of property. This Court also held in *Herring v. Commissioner*, 293 U. S. 322 (1934), that the *lessor* receiving advance royalties had retained a depletable economic interest in the property which was depleted by production, and was entitled to the depletion deduction with respect to advance royalties. The Circuit Court of Appeals held in the present case that, although the advance royalties were ordinary income to the *lessors* and the *lessors* retained depletable economic interests in the property, the same payments in the same transactions were a capital investment by the *lessee* whereby the *lessee* acquired a depletable economic interest in such property. Petitioner's basic claim is that the Court erred in thus treating the same transaction as giving rise to rights in the *lessee* which are fundamentally inconsistent with the rights reserved by the *lessor*.

Petitioner's alternative claim for a percentage depletion deduction on the current gross income allocable to advance royalties was rejected by the Court as contrary to the provisions of Article 23(m)-1(g) of Regulations 86 and 94, requiring the exclusion from gross income of the *lessee* of appropriate amounts "if royalties in the form of bonus payments or advance royalties have been paid." (Appendix p. 26). This regulation was regarded as applicable and as valid and binding on the petitioner if it elected to take the benefit of percentage depletion, notwithstanding the Court's holding that the advance royalties were a capital investment in a depletable interest as to which depletion based on cost could have been taken.

Judge Learned Hand dissented on the ground that the Court's decision was in conflict with the principles established by the Supreme Court in cases involving the receipt of advance royalties by *lessors*, and said that the majority

opinion treated the same lease as giving the lessee an immediate interest in the gas for one purpose, and as giving him no interest in it whatever until he actually withdrew it, for another purpose (R. 100).

Reasons Relied on for Allowance of this Writ.

The Writ of Certiorari should be issued on petitioner's first point because the holding of the Circuit Court of Appeals conflicts in principle with the decision of this Court that advance royalties are paid for units of gas and oil to be extracted from the lessor's reserved interest in the oil and gas in place. *Herring v. Commissioner* 293 U. S. 322, 324 (1934). This Court held that advance royalties are taxable to the lessor as ordinary income and not as proceeds from the sale or exchange of property, *Burnet v. Harmel*, 287 U. S. 103 (1932), and are depletable by him since he is the owner of the interest which will be exhausted by production, *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312 (1934); *Herring v. Commissioner*, 293 U. S. 322 (1934). In the very recent decision in *Kirby Petroleum Company v. Commissioner* U. S. (January 28, 1946) the Commissioner conceded that the depletion allowance of Sections 23(m) and 114 (b)(3) is applicable to bonuses and current royalties received by a lessor. The opinion of the Circuit Court of Appeals is based on the conflicting view that advance royalties are paid as consideration for an immediate depletable economic interest in the gas in place and not as the purchase price of the gas to be produced from the lessor's reserved interest. The Court erred in concluding that it could properly hold that the *lessee* by paying advance royalties was acquiring an immediate economic depletable interest in the gas in place, when the Supreme Court decisions

conclusively establish that the same transaction was not a disposition by the lessor of any such interest. Since the decision below is in direct conflict with the principles established by the Supreme Court, it should be reviewed by this Court.

This point raises an important question of federal law which has been wrongly decided below and has not been passed upon by this Court. The question affects a large majority of the oil and gas leases entered into in this country on a matter of vital importance to those engaged in the oil and gas industry. This question is highly important in the administration of the Internal Revenue Laws and should be settled by this Court.

The Writ should be granted on this point notwithstanding the denial of the Writ on the same question in *Sunray Oil Co. v. Commissioner*, 65 S. Ct. 1201 (1945). The dissenting opinion of Judge Learned Hand in the Court below conclusively demonstrates that the opinion of the majority is in direct conflict with decisions of this Court and cannot logically be reconciled with such decisions. In the *Sunray* case, furthermore, the alternative and interdependent claim for a percentage depletion deduction was not involved. The most important point in that case was the wholly unrelated question involving leases of state oil lands.

The Writ should also be issued on petitioner's alternative claim.

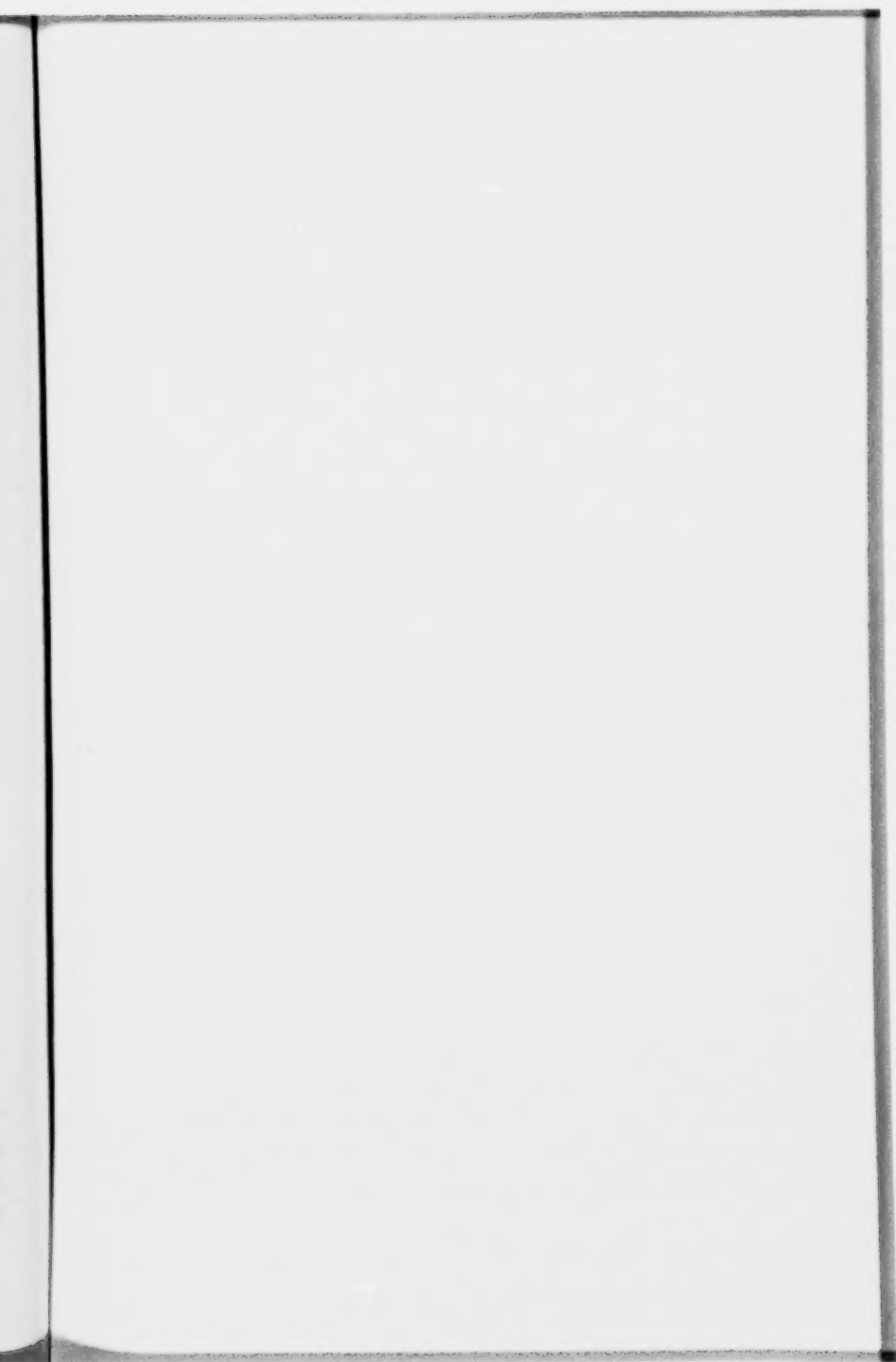
This claim is that if the current gross income allocable to advance royalties is petitioner's gross income because produced from an economic depletable interest in the gas in place acquired by it, petitioner is entitled to the depletion deduction with respect to such production, whether computed on the percentage basis or on the alternative cost basis. It was inconsistent for the Court below to hold that

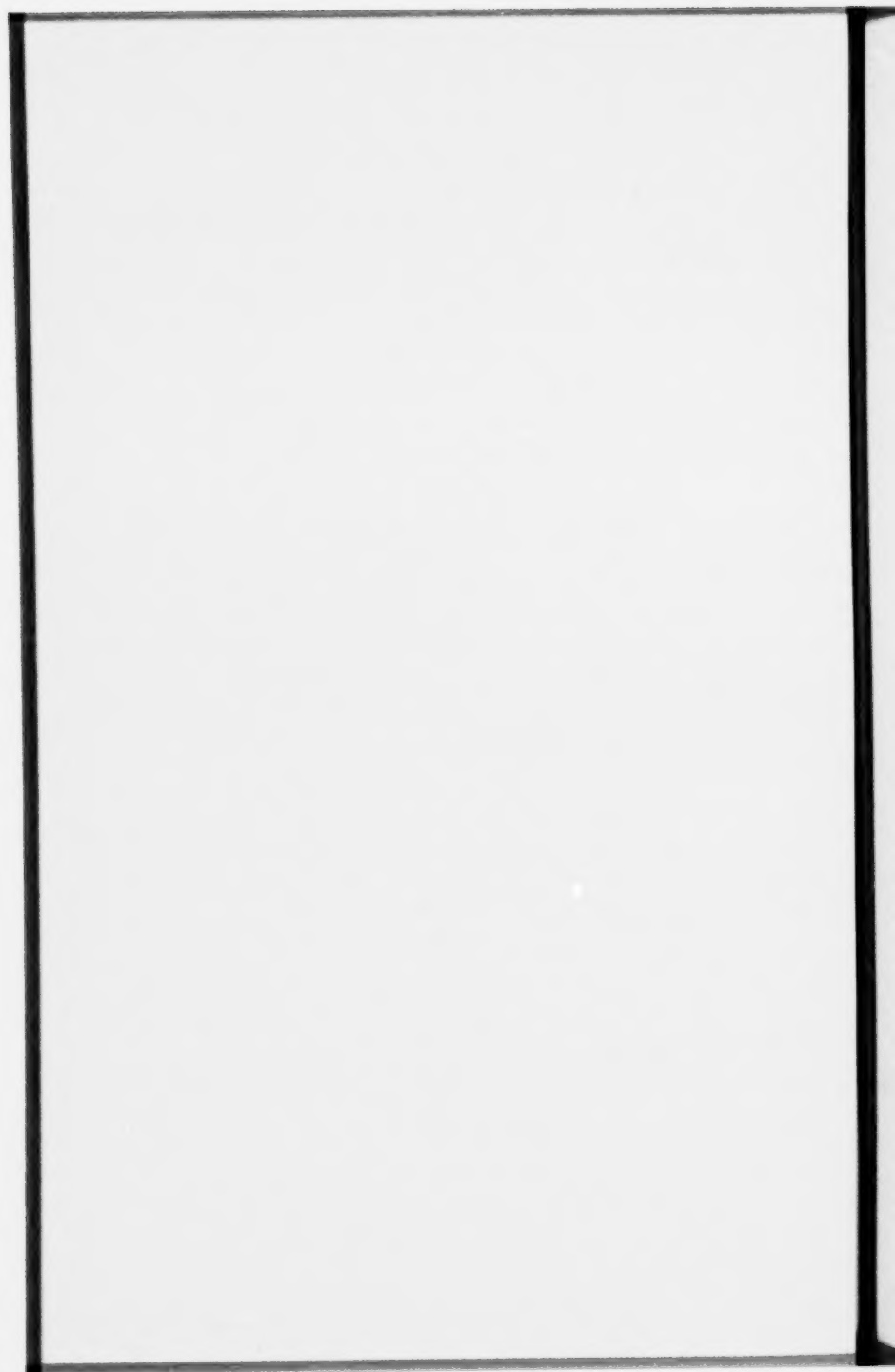
such gross income was produced from the lessee's depletable interest in the property and at the same time to deny the lessee depletion with respect to this share of its gross income. Such denial cannot be justified either on the ground that the amounts which the Court had held to be capital expenditures were "royalties" or on the ground that the Commissioner has power by regulation to deny or limit the percentage depletion deduction allowed by the plain terms of Section 114 (b)(3) of the Revenue Acts of 1934 and 1936. This question also is an important question of federal law which has not been, and should be, decided by this Court because it affects a large number of taxpayers, and is important in the administration of the Internal Revenue Laws.

WHEREFORE, petitioner respectfully prays that a Writ of Certiorari issue under the Seal of this Court to review the decision of the Circuit Court of Appeals for the Second Circuit in the above case.

CANADIAN RIVER GAS COMPANY,
Petitioner.

By ARTHUR A. BALLANTINE,
GEORGE E. CLEARY,
Counsel for Petitioner.





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Respondent.

**BRIEF IN SUPPORT OF PETITION
FOR CERTIORARI.****Questions Presented, Statement of Case, Statutes, Etc.**

The statement of the questions presented, the statement of the case, and the statutes involved will be found in the petition.

Specification of Errors and Summary of Argument.

1. The Circuit Court of Appeals erred in holding that advance royalties paid by a lessee constitute a capital investment by the lessee in a depletable wasting asset and do not constitute the purchase price paid in advance for gas to be produced from the lessor's reserved interest. Such decision is directly contrary in principle to decisions of the Supreme Court in cases involving lessors who received such advance royalties.

2. In the alternative, the Circuit Court of Appeals erred in denying petitioner the percentage depletion deduction on that portion of its gross income from the property allocable to such advance royalties. A regulation denying a taxpayer percentage depletion on part of its gross income from the property is contrary to the statute and invalid.

ARGUMENT.

I.

The Circuit Court of Appeals erred in holding that advance royalties paid by a lessee constitute a capital investment by the lessee in a depletable wasting asset and do not constitute the purchase price paid in advance for gas to be produced from the lessor's reserved interest. Such decision is directly contrary in principle to decisions of the Supreme Court in cases involving lessors who received such advance royalties.

The decision on petitioner's primary contention that the portion of advance royalties allocable to current production represents the cost to the lessee of gas produced from an interest reserved by the lessors in the gas in place, depends on a single basic question. By paying advance royalties to the lessors, was the petitioner-lessee (a) making a capital investment in a depletable wasting asset, as was held by the Court below, or (b) making payment in advance for gas to be extracted from a depletable wasting interest in the gas in place reserved by the lessors?

If the current production allocable to advance royalties was from a depletable interest in the gas in place which the lessee had purchased and owned, such production would, of course, be gross income of the lessee, as was held

below. But if such production was from an interest in the gas in place reserved and owned by the lessors, then the lessee acquired such gas when produced by purchase from the lessors, and the amount paid in advance by the lessee for such gas, namely, the portion of the advance royalty allocable to current production, was cost of goods, deductible by the lessee from gross sales in determining gross income (Article 22(a)-5, Treasury Regulations 86 and 94, Appendix, p. 26).

The decision below turned on this precise point. The current production allocable to advance royalties was held to be gross income of the *lessee* because it was regarded as production from an interest in the gas in place which the lessee had purchased by paying the advance royalties. The Court below refused to recognize that this portion of the production was from an interest in the gas in place reserved by the lessors and that the lessee acquired this share of the gas only by purchasing it from the lessors, the advance royalty being payment by the lessee in advance for gas to be extracted in the future from the lessors' retained interest.

Yet the Supreme Court has determined the status of advance royalties received by the lessor under such a lease. The petitioner "merely asks that the lease shall be construed in the same way, when the lessee is taxed" (R, 100).

As to advance royalties received by the lessor under such a lease, the Supreme Court has held:

(1) The lessor receiving an advance royalty under an oil and gas lease receives ordinary income and not capital gain from the disposition of any interest in the property (*Burnet v. Harmel*, 287 U. S. 103 [1932]).

(2) The advance royalty received by the lessor "is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted", is part

of the lessor's "gross income from the property" and the lessor is entitled to the percentage depletion deduction with respect thereto even though there is no current production in the year the advance royalty is received (*Herring v. Commissioner*, 293 U. S. 322, 324 [1934], *Kirby Petroleum Company v. Commissioner*, U. S. (January 28, 1946)). The lessor is likewise entitled to depletion based on cost if that is greater than the percentage depletion deduction (Article 23(m)-10, Regulations 86 and 94, Appendix, p. 26). Cf. *Murphy Oil Co. v. Burnet*, 287 U. S. 299 (1932).

(3) The depletion deduction allowed the lessor with respect to advance royalties is allowed in anticipation of future production from his retained depletable interest in the property. If there is no future production, and hence no depletion of such retained interest, the lessor must account for the anticipatory deductions so allowed as income in the year the lease is terminated (*Douglas v. Commissioner*, 322 U. S. 275 [1944]).

Depletion deductions are, of course, allowable only to those who have an economic interest in the oil and gas in place which is depleted by production (*Palmer v. Bender*, 287 U. S. 551 [1933], *Kirby Petroleum Company v. Commissioner*, U. S. (January 28, 1946)). Depletion cannot be allowed to anyone who does not have such an economic interest in the property which is depleted by production (*Helvering v. Bankline Oil Co.*, 303 U. S. 362 [1938]; *Helvering v. O'Donnell*, 303 U. S. 370 [1938]; *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372 [1938]; *Thomas v. Perkins*, 301 U. S. 655 [1937]).

As to the lessor receiving advance royalties under an oil and gas lease, it is therefore firmly settled that he has not made a sale of an interest in the property; that the

advance royalties are part of the lessor's gross income from the property and are ordinary income of the same nature as current royalties; that the lessor has reserved the economic depletable interest in the oil and gas in place represented by the advance royalties, and that the lessor is entitled to anticipatory depletion (on either the cost or percentage basis) with respect to such royalties because it is his reserved interest in the oil and gas in place which is wasted or depleted by the production allocable to advance royalties.

The Court below, although conceding in substance that these principles have been established as to the effect of the receipt of advance royalties by the lessor, nevertheless held that these identical payments had a different and wholly inconsistent effect when considered from the standpoint of the lessee.

The Court, in its opinion, said that the advance royalty paid by the lessee "was the consideration paid for an economic interest in the gas bearing land leased" and that the lessee by paying the advance royalty "obtained an asset which was depletable * * * because it was a wasting capital asset which was inherently depletable" and that the advance royalties "were paid as the consideration for the conveyance of a leasehold in which the plaintiff invested to obtain the right to produce gas from the land leased" (R. 99). We submit that this is a decision that the lessee, by paying the advance royalties, acquired a depletable interest in the property which the Supreme Court has held the lessors did not dispose of but retained. There were, of course, various interests in the property. Referring to 1934 production (R. 49), the interest in the gas in place represented by the current royalties of \$191,418.37 was retained by the lessors. The interest in the gas in place represented by the gross income of